NO. 80753-1

SUPREME COURT

OF THE STATE OF WASHINGTON

AMERICAN BEST FOOD, INC. a Washington corporation d/b/a CAFÉ ARIZONA; and MYUNG CHOL SEO and HYUN HEUI SE-JEONG,

Respondents,

v.

ALEA LONDON, LTD., a foreign corporation,

Petitioner.

RESPONDENTS' ANSWER TO BRIEF OF AMICUS CURIAE WASHINGTON STATE TRIAL LAWYERS ASSOCIATION FOUNDATION

Scott B. Easter
WA State Bar No. 5599
Benjamin I. VandenBerghe
WA State Bar No. 35477
MONTGOMERY PURDUE
BLANKINSHIP & AUSTIN PLLC
Attorneys for Respondents

5500 Columbia Center
701 Fifth Avenue
Seattle, WA 98104-7096
(206) 682-7090

Portions of this brief have been stricken per the notation ruling of 11-19-08

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I. INTRODUCTION

With the few exceptions and clarifications described herein, Respondents American Best Food, Inc. d/b/a Café Arizona and its operators Myung Chol Seo and Hun Heui Se-Jeong (collectively "Café Arizona") agree with and join in the Brief of Amicus Curiae Washington State Trial Lawyers Association Foundation ("WSTLA") ("WSTLA Brief"). WSTLA's analysis is on point and should guide the Court, as explained below.

II. FACTS

The facts of this case have been adequately briefed by the parties. For brevity, Café Arizona will not repeat relevant facts in this Answer and instead incorporates the facts sections from its prior briefing by this reference.

III. RESPONSE

A. WSTLA's Duty to Defend Analysis is Correct.

The authorities cited in the WSTLA Brief effectively outline the scope of the duty to defend in Washington. WSTLA correctly cites to an unbroken chain of Washington authority for the proposition that an insurer owes a duty to its insured to provide a defense "unless the claim alleged in the complaint is clearly not covered by the policy." *E.g., Woo v.*

Firemen's Fund Ins. Co., 161 Wn.2d 43, 53, 164 P.3d 454 (2007); *Truck Ins. Exch. v. Vanport Homes, Inc.*, 147 Wn.2d 751, 761, 58 P.3d 276 (2002).

B. WSTLA's Bad Faith Analysis and Proposed Standard to be Applied Here are Correct and Should be Extended.

It is uncontested that a finding of bad faith by Alea would result in coverage by estoppel here, and each party agrees there are no issues of fact to preclude a ruling on Café Arizona's bad faith claim as a matter of law. Thus, one of the key issues before the Court, as WSTLA correctly identifies, is whether Alea's wrongful refusal to defend Café Arizona constitutes bad faith as a matter of law.[1]

Alea argues it cannot be liable for bad faith despite its wrongful denial of its duty to defend because Alea believes its legal analysis, now ruled to be deeply flawed, was reasonable. WSTLA suggests the broad rule of reasonableness, mentioned in dicta with reference to the duty to defend for the first time in *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 560,

[1] As an initial matter, the WSTLA Brief cites to Alea's contention the Court should not reach the issue of Alea's bad faith. Alea misapprehends the appropriate scope of review. Café Arizona's broad arguments and reliance on bad faith case law in its Motion for Summary Judgment briefing adequately placed this issue before the court, and it has been preserved on appeal. Moreover, Alea's repeated requests for a contrary ruling on Café Arizona's bad faith and coverage by estoppel claims have opened the door for resolution of these claims in Café Arizona's favor. *Impecoven v. Dep't of Revenue*, 120 Wn.2d 357, 365, 841 P.2d 752 (1992). The Court of Appeals correctly considered these issues and they are properly before this Court.

951 P.2d 1124 (1998) (in which bad faith refusal to defend was presumed), should be clarified in light of more recent decisions detailing the parameters and breadth of an insurer's duty to defend. WSTLA Brief at fn. 10. Café Arizona joins WSTLA in its invitation to the Court to clarify the standard to be applied to determine when the breach of the duty to defend constitutes bad faith.

Applying the test of when a defense may be denied which was applied in *Vanport* and recently reaffirmed in *Woo*, it is readily apparent Alea failed to apply that standard ("clearly not covered") and therefore breached its duty to defend in bad faith. Instead, Alea consciously elected to gamble on how the court would rule on a matter of first impression and denied Café Arizona a defense. There was no Washington law on point. By giving itself the benefit of the doubt, Alea deprived Café Arizona of one of the most important benefits of its insurance policy, and did so based on a flawed and untested legal theory.

1. WSTLA Properly Concludes the Appropriate Test to Apply is Whether it is Reasonably Debatable that the Underlying Claims were Clearly not Covered.

A key distinction between the analyses of Alea and the Industry Amici[2] on the one hand and WSTLA and Café Arizona on the other is how to apply the test of the "reasonableness" of Alea's actions in refusing to defend Café Arizona based on its flawed and ultimately incorrect prediction of how a Washington appellate court would rule on the issue of the application of an assault and battery exclusion ("A/B Exclusion") to a claim of post-assault negligence. Whereas Alea and the Industry Amici erroneously conclude a mere determination of reasonableness with respect to the ultimate indemnity issue is all that is required, WSTLA correctly points out that in a case like this one where the insured alleges bad faith breach of the duty to defend, the correct standard must be whether the insurer's actions *with regard to denying a defense* were reasonable.

Because under *Vanport* an insurer may only deny defense of a claim that is clearly not covered, it is the reasonableness of this determination which must be reviewed to determine whether the

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[2] The authors of the Brief of Amicus Curiae Professor Karen Weaver and Interested London Insurers and the Brief of Amicus Curiae State Farm Fire & Casualty Company are collectively referred to herein as "Industry Amici."

requirements for bad faith are met. As such, the appropriate test should be whether it is reasonably debatable that the claims are "clearly not covered." By attempting to shift the analysis to whether the insurer's underlying coverage position (for indemnity purposes) was reasonably debatable, Alea and the Industry Amici would side-step review of the crucial initial determination of when a defense can be denied: whether the claim was clearly not covered, such that the insurer may with impunity, and without first commencing a declaratory action, simply deny the defense.

Café Arizona joins WSTLA in requesting the Court clarify the standard to be applied to bad faith claims related to a wrongful breach of the duty to defend: namely requiring the insurer to make a reasonable determination that the underlying claims are clearly not covered. Given the laudable policy behind this Court's repeated warnings to the insurance industry of the insurer's duty to defend and the availability of the declaratory action and safe harbor of defending under a reservation of rights, as clearly articulated in *Vanport* and *Woo*, this proposed standard is a logical and reasonable extension of this Court's prior holdings and will provide a bright line rule to guide insurers in the future.

WSTLA effectively argues in its brief how Alea's conduct here violates this standard, and Café Arizona incorporates WSTLA's arguments by this reference.

2. The Court Should Apply a Presumption of Unreasonableness When an Insurer Breaches its Duty to Defend.

The law currently requires an insured pursuing a bad faith claim to prove its insurer's breach of the insurance contract to indemnify was unreasonable, frivolous, or unfounded. *E.g., Smith v. Safeco Ins. Co.*, 150 Wn.2d 478, 484, 78 P.3d 1274 (2003). *Kirk* cited to this rule in dicta in the context of the question certified, namely the nature of the remedy assuming the insurer fails to provide a defense to the insured in bad faith. *Vanport*, decided after *Kirk*, makes it clear that an insurer in narrowly construing, as it must, an exclusion, may only deny a defense where the claims are clearly not covered. Alea in this case and the insurers in *Woo*, published since this case was decided by the Court of Appeals, engaged in bad faith in their unreasoned refusal to apply this rule in a fashion that recognized the duty to defend. The application of this rule to the facts of this case invite additional consideration by the Court as to whether such a rule, left unrefined, serves the purpose of providing an adequate disincentive to insurers who may deny a defense to their insureds in bad

faith, forcing the insureds, as in this case and *Woo*, to litigate simply to receive the benefits of a defense.

Alea and the Industry Amici rely largely on *Kirk* for the proposition that Alea could not have acted in bad faith if its legal theories supporting the underlying indemnity analysis were reasonable. As pointed out by WSTLA, the *Kirk* decision is not binding authority for this proposition. In fact, the issue of how to apply the rule of reasonableness to a bad faith claim where the duty to defend is at issue, as opposed to the duty to indemnify or another duty under the insurance contract, is not squarely addressed by *Kirk* and is ripe for consideration by the Court here.

The difficulty with the reasonableness rule as applied to a breach of the duty to defend is that it provides an incentive for an insurer to simply deny a defense when facing a questionable duty to defend and gamble its insured will be unable or unwilling to pick up the gauntlet thrown down by its insurer and sue for bad faith. As the burden of proof for a bad faith claim rests with the insured, the self-interested insurer has additional incentive not to defend with the knowledge that bad faith may be difficult for its insured to establish even if the insured has the financial wherewithal to sue. Providing insurers such an incentive to abandon their insurers flies in the face of recent opinions by this Court regarding the breadth of the duty to defend and the obligation of insurers to seek judicial

guidance by initiating a declaratory action where the existence of such a duty is reasonably debatable.

(a) This Court has recently emphasized how crucial it is for an insurer to defend under a reservation of rights and file a declaratory action when the duty to defend is not clearly absent.

This Court has repeatedly emphasized the safe harbor provided to insurers by filing a declaratory action while defending under a reservation of rights. *E.g., Vanport*, 147 Wn.2d at 761; *Woo*, 161 Wn.2d at 54. The statement in *Kirk* that an insurer need only have a reasonable justification for denying indemnity or a defense should be reconsidered in light of later decisions of this Court, which emphasize the responsibility of an insurer to defend under a reservation of rights and file a declaratory action when faced with a questionable claim where the duty to defend may or may not arise. The necessity of this course of action is emphasized not only because of its ease and speed, which benefit the insurer, but most importantly to avoid the extreme prejudice to the insured of being abandoned by its carrier in the face of a lawsuit it may be unable to afford and unequipped to defend.

In *Vanport*, a construction consulting firm was sued by several of its customers and tendered defense to its commercial general liability insurer. The insurer did not respond to the tender of defense for more than

a year, when it finally denied a defense without explanation. The insurer eventually filed a declaratory judgment action seeking a declaration it had no duty to defend or indemnify its insured. 147 Wn.2d at 756-57. The trial court ruled that the insurer breached its duty to defend and made a finding of bad faith and violation of the CPA. *Id.* at 759. This Court upheld the breach of the duty to defend since the claim alleged failed to meet the test of "clearly not covered." *Id.* at 763. Regarding the insurer's options, the court reasoned: "[p]ut simply, an insurer may not rely on facts extrinsic to the complaint in order to *deny* its duty to defend where, as here, the complaint can be interpreted as triggering the duty to defend. If in doubt, it may file a declaratory action." *Id.* at 761. The court continued:

> Once the duty to defend attaches, insurers may not desert policyholders and allow them to incur substantial legal costs while waiting for an indemnity determination. If the insurer is unsure of its obligation to defend in a given instance, it may defend under a reservation of rights while seeking a declaratory judgment that it has no duty to defend. A reservation of rights is a means by which the insurer avoids breaching its duty to defend while seeking to avoid waiver and estoppel. When that course of action is taken, the insured receives the defense promised and, if coverage is found not to exist, the insurer will not be obligated to pay.

Id. (Internal citations omitted).

In *Woo*, a dentist was sued for playing a ill-conceived practical joke on an employee, and he tendered defense of the claim to his insurer. 161 Wn.2d at 457-58. The insurer denied a defense, so the insured paid for his own defense and sued his insurer for breach of its duty to defend and bad faith, among other things. The court granted summary judgment in favor of the insured on the breach of the duty to defend issue, and the jury ultimately determined the insurer acted in bad faith. The insurer appealed and the Court of Appeals reversed the trial court's ruling on the breach of the duty to defend and remanded for dismissal. The insured appealed to this Court, which reached only the issue of the breach of the duty to defend, as the issue of bad faith was not before the Court of Appeals. *Id.* at 458. This Court cited to the language quoted above from *Vanport* to emphasize the availability of a declaratory action "if the insurer is uncertain of its duty to defend" *Id.* at 460, and ultimately reversed the Court of Appeals, determining instead that the insurer did in fact breach its duty to defend. *Id.* at 463.

As WSTLA points out, the very tactic utilized by Alea in this case was advanced by the insurer in *Woo*. In *Woo*, the insurer refused to defend relying on two cases which were factually distinguishable. This Court ruled that by relying on its own interpretation of case law to deny a defense to its insured, the insurer impermissibly gave itself the benefit of

the doubt on the duty to defend issue instead of giving the benefit of the doubt to its insured. *Id.* at 463. The follow-up question of whether this breach constitutes bad faith was never addressed in *Woo*.[3]

Both *Vanport* and *Woo* hold that an insurer's duty to defend requires an insurer to defend under a reservation of rights and start a declaratory action if its duty to defend is not clearly absent. This rule is especially important in cases like this one and *Woo* where the question of coverage relates to an absence of clear Washington law on point to guide the parties. Under these circumstances, whether the duty to defend exists cannot be ascertained without a judicial determination of the matter of first impression, and a declaratory action is the fastest way to obtain such a ruling. Given the absence of controlling law, the insurer cannot possibly argue the claims are "clearly not covered" as it must to properly deny a defense.

The question, then, is whether the rule of reasonableness from *Kirk*, without refinement, serves to properly motivate insurers to offer a defense under a reservation of rights and take this safe harbor course of action when the duty to defend rests upon an unsettled point of law. Café Arizona suggests it does not.

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[3] The issue of bad faith was also assumed for the purpose of the certified question

(b) Shifting the burden of proving reasonableness to the insurer would motivate insurers to seek judicial guidance where the duty to defend is unclear.

Shifting the burden of proving reasonableness to an insurer that breaches its duty to defend would provide additional incentive for insurers to defend under a reservation of rights and seek declaratory judgment where the existence of the duty is debatable, and is therefore wholly consistent with the *Vanport* line of cases from this Court. Breach of the duty to defend would create a rebuttable presumption of bad faith. Under this approach the insurer would have the burden, in the present case, to show it was not reasonably debatable that the underlying post-assault claims were clearly not covered.

The argument for burden shifting to an insurance company is not a new one. In *Safeco v. Butler*, this Court shifted the burden onto the insurer of demonstrating there was no harm arising from bad faith by the insurer. 118 Wn.2d 383, 390, 823 P.2d 499 (1992). The Court applied this presumption of harm to lessen the burden on the insured pursuing such a claim. *Id.* Thus, there is precedent even within this specific area of the law in support of a burden shifting policy against a breaching insurer.

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presented in *Kirk*.

Applying a presumption of unreasonableness here serves the same purpose as the burden shift applied by this Court in *Butler*. If an insured is denied a defense, it will automatically face the expense and risk of the underlying claim without the benefit of the defense for which it contracted and paid. If it cannot prove the outcome of the underlying case would have been more favorable if a defense had been offered, the insured's remedy may be limited to reimbursement of costs of defense. In the face of a recalcitrant insurer, the insured's only option to secure coverage is the daunting task of suing its insurer for bad faith breach of contract. Thus, the insured is not only forced to defend itself at its own expense, but must make the financial, emotional, and resource commitment to file a second and likely concurrent lawsuit against its insurer if it hopes to secure the benefits of its policy.

Under the current state of the law, the insured must then also bear the burden of proving its insurer's refusal to defend was unreasonable and therefore constitutes bad faith, even where the refusal is later demonstrated to have been in breach of the insurer's duty to defend. This burden prejudices the insured in light of the difficult situation its insurer has placed the insured in by denying a defense. This burden of proof also acts as an incentive to an insurer to deny a defense if it can "with a straight

face" articulate a legal theory to support denial even where the claims cannot be said to be "clearly not covered" as required by law.

The case before the Court presents exactly this situation, and exemplifies why a burden shifting rule is required. Here, the underlying claims fell within the broad grant of coverage, so Alea owed Café Arizona a duty to defend unless the underlying claims were clearly not covered. Because no Washington decision had ever analyzed claims of post-assault negligence under an A/B Exclusion, Alea had no directly controlling case law to guide its decision on its duty to defend. Instead of defending under a reservation of rights and submitting the undecided issue to the court for determination, as this Court has repeatedly admonished insurers to do when the duty to defend is questionable, Alea made a bet at the expense of its insured that a court would extend the *McAllister v. Agora Syndicate, Inc.*, 103 Wn. App. 106, 11 P.3d 859 (2000) case to preclude coverage for post-assault claims despite the fact that the claims in *McAllister* were pre-assault claims. With this lack of authority in hand, Alea refused to defend Café Arizona and left it to fend for itself. As Alea has now pointed out in its brief, it believes it was justified to do so despite the fact its coverage position was wrong because Café Arizona bears the burden of proving Alea's legal analysis was unreasonable. Supplemental Brief of Petitioner Alea London, Ltd. at 13.

Alea has done in this case precisely what this Court forbade an insurer to do in *Woo*; it denied a defense when the issue was one of first impression in Washington. It put its own financial interests ahead of its insured and gambled it either would not be challenged or if it was sued that it would argue for an extension of Washington law to justify its denial of a defense. Finally, it used incorrect legal analysis to justify its refusal to defend its insured.

Instead of forcing Café Arizona to meet its burden of proof by laboriously picking apart the theory Alea now alleges in support of its denial, this Court should apply a presumption that an insurer that breaches its duty to defend has done so unreasonably. This would place the burden of proof on the party that elected to take the risk of litigation in the first place, by denying a defense and inviting a lawsuit for bad faith breach of its duty to defend, instead of leaving the burden on an insured that has been forced to litigate for coverage. Such a policy would be wholly consistent with this Court's rulings in *Vanport* and *Woo*, and would serve as an additional and necessary incentive to insurers to take the simple step of defending under a reservation of rights and filing a declaratory action if there is any question of the existence of the duty to defend.

To allow the burden to remain on the insured defeats the purpose of applying the "clearly not covered" standard to the duty to defend in the

first place and encourages insurers to deny a defense and take the risk their insured will run out of money before it can meet its burden of proof to prevail on a bad faith claim.

C. Alea's Breach of its Duty to Defend Constitutes Bad Faith as a Matter of Law.

Although Café Arizona suggests that adopting a rule of shifting the burden to the insurer to prove reasonableness after it has breached its duty to defend should be applied in this case, it is not necessary for the Court to adopt this approach to find in Café Arizona's favor on the bad faith issue as a matter of law. Café Arizona addresses this issue at length in its briefing below, its Answer to the Petition for Review, its Supplemental Brief, and in its Answer to the Brief of Amicus Curiae Professor Karen Weaver and Interested London Insurers. For the sake of brevity, these arguments will not be repeated here at length and are incorporated by this reference.

In brief summary, Alea's refusal to defend was not based on a reasonable interpretation of the A/B Exclusion or a reasonable application of Washington law because the A/B Exclusion did not clearly preclude coverage for the underlying claims of post-assault negligence. There was no Washington case on point dealing with this issue, other jurisdictions to consider the issue found for coverage, and Alea had a duty to interpret the

A/B Exclusion narrowly and in favor of the reasonable possibility of coverage. Under these circumstances, Alea's reliance on the inapposite holding from *McAllister* was neither a reasonable coverage position nor a reasonable application of the *Vanport* test requiring a defense except where a claim is clearly not covered. Alea breached its duty to defend in bad faith, and the Court should find bad faith as a matter of law and apply coverage by estoppel as argued in Café Arizona's previous briefs.

D. Café Arizona's CPA Claim Should Be Granted as a Matter of Law.

The Court of Appeals affirmed dismissal of Café Arizona's Consumer Protection Act claims premised upon per se violations of WAC 284-30-330. This was error. Violations of WAC 284-30-330 are per se violations of the Consumer Protection Act, and support a finding of bad faith. *Vanport*, 147 Wn.2d at 764.

WSTLA appropriately emphasizes Alea's multiple violations of Washington law in its failure to investigate Café Arizona's tender. Alea's failure to investigate stems not only from its failure to investigate the facts, which would have led to the inevitable conclusion that Dorsey alleged separate and distinct injuries sustained from the conduct of Café Arizona's employees described in his post-assault negligence claims, but stems also from Alea's failure to properly investigate the law. WSTLA

correctly points out that such failure violates WAC 284-30-330(13) in addition to the subsections of WAC 284-30-330 specifically listed in Café Arizona's previous briefs, and Café Arizona agrees this is an additional basis for finding as a matter of law that Alea violated the Consumer Protection Act.

WAC 284-30-330(13) defines as an unfair insurance practice "Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement." Thus, denial of a claim must carry a reasonable explanation of the basis for the decision. *Ins. Co. of State of Pennsylvania v. Highlands Ins. Co.*, 59 Wn. App. 782, 789, 801 P.2d 284 (1990). Alea's failure to adequately investigate the law and failure to adequately explain its legal conclusions to Café Arizona constitute per se violations of the CPA.

IV. CONCLUSION

This case demonstrates that currently insurers do not have adequate incentive to take the simple step of defending under a reservation of rights and filing a declaratory action where coverage is not clearly precluded. To provide such an incentive, the Court should clarify that 1) an insurer breaches its duty to defend by denying a defense unless it is reasonably debatable that the claims are clearly not covered; and 2) if an

insurer breaches its duty to defend, the courts will impose a rebuttable presumption that the insurer breached its duty in bad faith. For the reasons stated above, Café Arizona joins in and requests the court adopt and extend the analysis from the WSTLA Brief.

RESPECTFULLY SUBMITTED this 13th day of October, 2008

MONTGOMERY PURDUE
BLANKINSHIP & AUSTIN PLLC

By _____
Scott B. Easter
WA State Bar No. 5599
Benjamin I. VandenBerghe
WA State Bar No. 35477
MONTGOMERY PURDUE
BLANKINSHIP & AUSTIN PLLC
Attorneys for Respondents

CERTIFICATE OF SERVICE

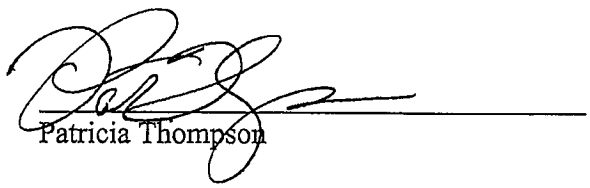
The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct:

That on October 13, 2008, I caused to be delivered by email, pursuant to prior authorization, a true and correct copy of Respondents American Best Food, Inc. d/b/a Café Arizona, Myung Chol Seo, and Hyun Heui Se-Jeong's Answer to Brief of Amicus Curiae Washington State Trial Lawyers Association Foundation to:

Counsel for Petitioner: J.C. Ditzler Melissa O'Loughlin White Molly K. Siebert Cozen O'Connor Suite 5200, Washington Mutual Tower 1201 Third Avenue Seattle, WA 98101-3071 jditzler@cozen.com mwhite@cozen.com msiebert@cozen.com	**Counsel for Petitioner:** Philip A. Talmadge Talmadge/Fitzpatrick PLLC 18010 Southcenter Parkway Tukwila, WA 98188-4630 phil@tal-fitzlaw.com
Amicus Curiae: David M. Beninger 705 5th Avenue, Suite 6700 Seattle, WA 98104 David@LuveraLawFirm.com Bryan P. Harnetiaux 517 E. 17th Avenue Spokane, WA 99203 AMICUSWSTLAF@winstoncashatt.com	**Amicus Curiae:** Pamela A. Okano Michael S. Rogers Reed McClure Two Union Square 601 Union Street, Suite 1500 Seattle, WA 98101-1363 pokano@rmlaw.com mrogers@rmlaw.com

Amicus Curiae: Karen Southworth Weaver Soha & Lang, PS 701 – 5th Avenue, Suite 2400 Seattle, Washington 98104 weaver@sohalang.com	

DATED this 13th day of October, 2008, at Seattle, Washington.



Patricia Thompson